

Internal Revenue Service
memorandum

CC:TL-N-89-89
Brl:JLRood

date: NOV 21 1988

to: District Counsel, [REDACTED]

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This is in response to your request for technical advice dated September 26, 1988.

ISSUE

Whether the Service should litigate the customer deposit issue in the above-referenced case in light of relevant Connecticut statutes. 0451-1300

CONCLUSION

In light of the recent government defeat in Indianapolis Power & Light Co. v. Commissioner, No. 87-2483 (7th Cir. September 20, 1988), which creates a conflict with the Eleventh Circuit, we do not recommend further litigation of this issue in the Tax Court until our recommendation for certiorari is acted upon.

FACTS

The instant case would be appealable to the [REDACTED] Circuit which has never addressed the customer deposit issue. Generally, the facts of the instant case are identical to the facts in Indianapolis Power with a few variations. Apparently, a lower percentage of [REDACTED] customers made deposits than Indianapolis Power customers. While 6% of Indianapolis Power customers made deposits, only between [REDACTED] and [REDACTED] of [REDACTED] customers made deposits between [REDACTED] and [REDACTED]. Moreover, most of the [REDACTED] deposits were returned to the customers rather than credited to their bills. Note that we are relying upon information in petitioner's counsel's letter.

The [REDACTED] statutes give additional protection to customers with respect to their deposits. First, under [REDACTED] law, the deposits are considered liabilities. Second, the statutes require the payment of interest on the deposits. Lastly, the statutes do not permit the automatic application of deposits against unpaid bills; rather customers

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must be given notice and a specific amount of time to reinstate their accounts before deposits may be applied. Moreover, severe illness may further extend the time in which a customer has to reinstate his account.

DISCUSSION

Basically, the customer deposit issue is whether deposits that secure future bills are taxable advance payments or are nontaxable security deposits.

There is currently a conflict between two circuits regarding the taxability of customer deposits. In City Gas Co. of Florida v. Commissioner, 689 F.2d 943 (11th Cir. 1982), rev'g and rem'g, 74 T.C. 386 (1980), the Eleventh Circuit applied the objective primary purpose test. Under this test, if the primary purpose of a payment is to act as a prepayment for goods and services, the amount constitutes taxable income. If, however, the primary purpose is to secure performance of nonincome producing covenants or to secure against damage to property, the payment is not taxable.

The Eleventh Circuit held that the customer deposits were income upon receipt because their primary purpose was to act as a prepayment for services. In so holding, the court also focused on the fact that the taxpayer had unrestricted use of the deposited funds subject to the contingent obligation to refund. The Service also applies the primary purpose test and agrees with the holding in City Gas.

In Indianapolis Power, Tax Court applied a subjective facts and circumstances test and held that the customer deposits in that instance were nontaxable. The court examined several factors in determining that deposits were held temporarily by the utility to secure payment of bills. The following factors were of particular importance to the court: 1) most customers were not required to make deposits; 2) customers controlled the method and timing of refunds; 3) the taxpayer did not treat the deposits as belonging to it; and 4) the taxpayer paid interest on the deposits. Based on these factors, the court found that customers retained substantial rights in the deposits which mitigated the taxpayer's rights in the amounts.

The Seventh Circuit affirmed the Tax Court in Indianapolis Power, but adopted a slightly different test. The court agreed that advance payments of income are taxable in the year of receipt. However, the court characterized the deposits as security deposits rather than as prepayments because the taxpayer had an obligation to repay the deposits in most instances. While the obligation to refund is not strictly controlling, the court noted that since repayment is likely, the amounts are nontaxable

security deposits even though they secure the performance of income payments.

We have recommended that a petition for certiorari be filed with respect to Indianapolis Power. We feel that the opinion is vulnerable because the Seventh Circuit disregarded the inherent relationship of the deposits to payment of income items. In other words, the court removed deposits which secure the performance of income payments from the taxable income category.

In the instant case, petitioner's counsel suggests that selected statutes in the [REDACTED] Code make the petitioner's case stronger than the taxpayer's case in Indianapolis Power. Under the primary purpose test the [REDACTED] statutes have no effect on the issue of whether customer deposits are taxable income.

The [REDACTED] statutes are irrelevant under the primary purpose test for several reasons. First, although the statutes classify customer deposits as liabilities, such a classification is irrelevant for federal tax purposes. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979); American Automobile Association v. United States, 367 U.S. 687, 693 (1961).

The fact that [REDACTED] law requires the payment of interest is also irrelevant. In City Gas, the Eleventh Circuit noted that "[a]lthough some courts have said that payment of interest is a factor suggestive of a nontaxable deposit..., other courts have recognized that interest may reflect compensation for the advance payment of income items as well. United States v. Williams, 395 F.2d 508, 511 (5th Cir. 1968); Commissioner v. Lyon, 97 F.2d 70, 74 (9th Cir. 1938)." City Gas Co. of Florida v. Commissioner, 689 F.2d at 948, n. 7. However, in Indianapolis Power, the Seventh Circuit relied heavily upon the fact that the taxpayer paid interest on the deposits.

The [REDACTED] statutes also prohibit the automatic application of a deposit against an unpaid bill. Instead, the statutes mandate that a customer be given a specific amount of time to reinstate his account. Moreover, severe illness may further extend the time in which a customer has to reinstate his account. However, these provisions merely extend the time in which a deposit may be credited to a customer's account, they do not eliminate the possibility of such a credit. The central issue remains whether the primary purpose of the deposit is to secure payment for services rendered. The time a deposit can be applied to an unpaid account is irrelevant.

Although under the primary purpose test the provisions of the [REDACTED] statutes have little relevance, the Tax Court uses the facts and circumstances test. Since, under the facts and circumstances test, the extent of the customers' rights

regarding reimbursement of deposits is deemed to affect a utility's control of the deposits, the Tax Court would likely utilize the statutes to the taxpayer's advantage. Moreover, a court that applies the Seventh Circuit's test could find that the statutes make the amounts look much more like security deposits than prepayments. Additionally, we do not know what test the [REDACTED] would apply on appeal.

We would have no objection if you want to settle this case. Alternatively, we suggest that you request the Tax Court to hold the case in abeyance until the petition for certiorari has been acted upon. If you are unable to settle the case or have it held in abeyance pending Supreme Court review of the issue, you should proceed with the case in accordance with the primary purpose test which is currently our position.

If you have any questions, contact Joan Rood at FTS 566-3521.

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